

State Board of Equalization
OPERATIONS MEMO
For Public Release

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SUBJECT: Alternative Method of Reporting Use Tax

I. GENERAL

Ex-tax purchases subject to use tax are ultimately the tax liability of the purchaser storing, using or otherwise consuming the property in this state, and ex-tax purchases subject to transactions and use tax (district tax) are ultimately the liability of the purchaser when purchased for use in a district imposing such a tax and thereafter used there.

The Alternative Method for Reporting Use Tax (AMRUT) Program is a process whereby a taxpayer can write to the State Board of Equalization (BOE) and propose a prospective use tax reporting method for qualified purchases subject to use tax. The alternative reporting method replaces the usual method of reporting use tax on a transaction-by-transaction basis. The alternative reporting method will not allow a taxpayer to issue resale or exemption certificates to vendors solely for the purpose of directly reporting the use tax under this AMRUT Program. The taxpayer's proposal must address the following matters:

- The remittance of use tax directly to the BOE on certain mutually agreed-upon categories of purchases.
- The application of a mutually agreed-upon taxable percentage to the taxpayer's total purchases for these categories to determine the tax.

If the BOE concludes the proposed reporting method accurately reflects the taxpayer's use tax liability for the defined population, the BOE will prepare a written response to the taxpayer approving (subject to certain conditions) the use of the proposed reporting method. This written correspondence is required for an approved AMRUT.

In general, audits of purchases covered by the BOE-approved reporting method will not ascertain whether or not tax was overpaid or underpaid on a transaction-by-transaction basis. Instead, the audit will determine whether or not the taxpayer complied with the criteria specified in the BOE-approved AMRUT. Audits of purchases outside the scope of the BOE-approved AMRUT, such as purchases of fixed assets, should be examined in accordance with existing audit procedures.

II. ELIGIBILITY

The BOE encourages participation in this program and will not restrict eligibility to any particular taxpayer, regardless of the size or type of business. In order to be eligible to participate in the program, the taxpayer must be registered with the BOE to report sales and/or use tax, be in good standing, and maintain acceptable accounting records and internal controls in accordance with the provisions of Regulation 1698, *Records*. Taxpayers requesting approval must provide the necessary accounting records upon request in a timely manner. When records are maintained electronically, the taxpayer shall provide data files requested by BOE staff in a timely manner.

Ideal candidates for this program include taxpayers who typically have large volumes of recurring purchases subject to use tax. The taxpayer's business and purchasing practices must be consistent.

III. AMRUT APPROVAL PROCESS

The taxpayer initiates the request to participate in the AMRUT Program by submitting a written request to the District Principal Auditor in the taxpayer's district of account. Requests must include:

- The taxpayer's name, address and seller's permit number
- The period for which the request is being made
- An assurance that the taxpayer's accounting records and internal controls are acceptable pursuant to the requirements of Regulation 1698
- Identification of any records that are maintained electronically

The BOE will only consider written requests for participation where the taxpayer is identified. Within 10 business days of receiving a request for participation, the district office will send an acknowledgment letter to the taxpayer providing information about the program, outlining the implementation process and soliciting additional information, if needed. The taxpayer will also be provided a BOE-472, *Use of Sampling in Auditing*, to complete prior to beginning the taxable percentage calculation. District audit staff will work with the taxpayer to determine the agreed-upon categories of purchases and the taxable reporting percentage. This process should be completed within 90 days after the taxpayer's accounting records are made available.

After completion of the taxable percentage calculation, the District Principal Auditor will prepare a memo to the Supervisor, Audit and Information Section (AIS) containing the staff's recommendation regarding the taxpayer's participation in AMRUT. The memo should include all details regarding the taxable percentage calculation and a copy of the completed BOE-472. The AIS Supervisor will review the materials and notify the District Principal Auditor in writing of approval or denial of the taxpayer's participation in AMRUT. The District Principal Auditor will then furnish a letter to the taxpayer, with a copy to the AIS Supervisor, approving or denying the taxpayer's request. If approved, the letter to the taxpayer must also include all details regarding the AMRUT, such as the taxable percentage to be used, the purchases the taxable percentage applies to, and the time period AMRUT is effective. Additionally, general information about the program, such as termination or the definition of a significant business

change, must be provided to the taxpayer. This may be accomplished by providing the taxpayer with a copy of this Operations Memo.

IV. TAXABLE PERCENTAGE CALCULATION

A. Base Period Selection

It is essential to select a mutually acceptable base period and scope of purchases covered by the proposed AMRUT. If currently under audit, the base period is typically the current audit period. However, the taxpayer and BOE staff may select transactions occurring over some other period if necessary. At a minimum, 12 months of detailed accounting records, which includes the most recent reporting period, should be used to calculate the taxable percentage. When this minimum is used, summary accounting records from the two preceding years must be provided for comparison purposes.

When selecting a base period, it is essential the tested purchases are representative of the taxpayer's normal purchasing activity and anticipated activity in future filing periods.

B. Taxable Percentage Calculation

The most important element of this reporting method is the calculation of the taxable percentage to be applied prospectively to purchases within the defined population. Under this method, the taxpayer will calculate (with BOE staff involvement) a taxable percentage to be applied to purchases from specific categories of transactions. Percentages are calculated as follows:

1. Determine which of the examined purchases in the base period are subject to use tax.
2. Divide the resulting taxable purchases by total purchases in the base period.

The total purchases subject to use tax for the approved period is calculated by applying the taxable percentage to total purchases from the same specified categories of transactions.

The taxable percentage calculation may be based on statistical sampling, non-statistical sampling or a detailed review of the transactions in the base period. However, both the taxpayer and BOE staff must agree on the sampling plan and procedures used to calculate the taxable percentage.

The taxable percentage calculation and application are limited to qualified purchases. This excludes specific categories of transactions such as fixed asset acquisitions and other accounts or transactions the taxpayer or BOE staff believes are atypical (e.g., resale inventory withdrawals, inter-company purchases, etc.) and should not be included in the defined population. Fixed asset acquisitions are excluded since these purchases generally are one-time transactions. Atypical purchases skew the taxable percentage calculation and negate the validity of the sample.

It may be necessary to calculate more than one taxable percentage to be applied to different categories of purchases. Computation of different percentages may be established by:

- Account number(s)
- Subsidiary
- Location
- Division
- Computer accounting system
- District tax
- Other criterion that makes business sense and produces a reliable and verifiable estimate of the taxpayer's use tax liability.

C. Sample Selection

To establish a prospective taxable percentage, a sample may be drawn from transactions that occurred in prior periods. Whenever sampling techniques are used, an estimate is made instead of using the actual result from a detailed review of the population. Therefore, the sample must be representative of the population. It is expected that the sample results will approximate the use tax currently being reported on a transaction-by-transaction basis for qualified purchases after considering BOE audit adjustments (if applicable).

BOE staff must be involved in the sample selection process. Prior to beginning the process, the taxpayer will complete a preliminary BOE-472. Both the taxpayer and BOE staff must agree to the sampling plan and then a final BOE-472 will be completed.

If statistical sampling techniques are used, the sample results will be evaluated to determine how accurately the sample reflects the population. Statistical sampling techniques must be in accordance with Audit Manual Chapter 13, *Statistical Sampling*.

Revenue & Taxation Code section 6406 credits and atypical transactions encountered during base period testing will be reviewed and evaluated by BOE staff on a transaction-by-transaction basis.

D. Electronic Records

Generally, taxpayers that wish to report use tax using AMRUT will maintain and provide access to their accounting records in electronic format. Staff will be involved in the analysis of these records during the review and approval process. The taxpayer will be required to provide a data download of the necessary electronic accounting records, including control totals, to staff in a format prescribed by staff.

E. Disputed Transactions

The BOE will not issue a letter approving a taxpayer's proposal if the taxpayer and BOE staff cannot agree on a sampling plan or resolve disputes regarding individual sample transactions.

V. TERM

The taxpayer will be notified of the specific period for which the applicable percentage may be relied upon. Generally, this will be a 36-month period corresponding with the taxpayer's reporting basis. This information will be included in the letter from the District Principal Auditor to the taxpayer outlining the specific details of the AMRUT.

VI. RENEWAL

The BOE's approval to use AMRUT is not automatically renewable. However, nothing herein shall prohibit the BOE from approving an extension for subsequent time periods. The BOE retains the right to audit the taxpayer's records to determine if the taxpayer's business practices or operations have changed.

Renewals or extensions will be handled in the same manner as initial requests for participation in AMRUT as provided in Section III, *AMRUT Approval Process*. The taxpayer must initiate an extension or renewal request by submitting a written request to the District Principal Auditor. At the discretion of the District Principal Auditor, staff may recommend using the existing taxable percentage based on a review, to the extent deemed appropriate by the District Principal Auditor, of the taxpayer's records or staff may calculate a new taxable percentage as provided in Section IV, *Taxable Percentage Calculation*. After determining the taxable percentage, the District Principal Auditor will prepare a memo to the AIS Supervisor containing the staff's recommendation regarding the taxpayer's continued participation in AMRUT and all details regarding the taxable percentage calculation. The AIS Supervisor will notify in writing the District Principal Auditor of approval or denial of an extension in AMRUT for the taxpayer. The District Principal Auditor will then furnish a letter to the taxpayer, with a copy to the AIS Supervisor, approving or denying the taxpayer's extension request to participate in AMRUT. The letter to the taxpayer must also include all details regarding the AMRUT for the taxpayer, such as the taxable percentage to be used, the purchases the taxable percentage applies to, and the time period AMRUT is effective.

VII. TERMINATION/CANCELATION

The BOE may rescind its approval of the reporting method if the taxpayer fails to comply with any of the program's conditions. In addition, the written approval of the use tax reporting method is void if the taxpayer files a claim for refund for tax that had been reported based upon this reporting method.

Upon written notification to the taxpayer, the approved AMRUT shall be rescinded. The notification shall be effective as of a date specified by the BOE. Accordingly, the approved AMRUT becomes invalid the first day of the subsequent quarterly filing period, but no less than thirty (30) days after the effective date of the BOE's written notification.

At any time, the taxpayer may elect to discontinue reporting use tax based upon the approved AMRUT. The taxpayer must notify the BOE in writing of the election to discontinue the alternative reporting method within the quarterly filing period of the election.

Once the AMRUT is rescinded, cancelled, voided, or discontinued the AMRUT can no longer be relied upon as advice which may qualify for relief under RTC section 6596 except to the extent

that a transaction examined as part of the taxable percentage calculation is incorrectly classified as not being subject to use tax.

VIII. REVISED PERCENTAGES

A. Notification Requirements

The taxpayer is responsible for monitoring and advising the BOE of any activities that significantly affect the taxable percentage. These activities may require adjustments to the taxable percentage. Circumstances that require notification of the BOE include, but are not limited to:

- Changes in accounting policy – changes that affect the distribution of use tax transactions in the accounts covered under the AMRUT that would significantly affect the agreed-upon percentage.
- Changes in purchasing practices – changes in purchasing activities that would significantly affect the agreed-upon percentage.
- Other significant business changes, as discussed in detail below.

The taxpayer must provide written notification to the BOE of a significant change in the facts and circumstances upon which the BOE's approval is based. The notification must be provided to the District Principal Auditor in the district of account within 90 days of the significant change. A significant business change affecting the taxable percentage will terminate the approved AMRUT and the taxpayer will be required to request approval to use the new reporting percentage. If a request is made, the new reporting percentage shall be subject to review and approval by BOE staff, based upon the evaluation of the new information. The taxpayer will be allowed a reasonable period in which to provide documentation to support a revised percentage. Although the taxpayer may choose to report the tax liability using the revised percentages, the revised reporting percentage may not be relied upon for the purposes of Regulation 1705, which interprets and applies section 6596, until written approval is provided by the BOE. Therefore, if appropriate, the BOE will provide the taxpayer a new approval letter after reviewing the supporting documentation. Any new approval letter must be issued under the provisions provided in Section III, *AMRUT Approval Process*. The new reporting percentage shall become effective commencing the first day of the quarterly filing period following review and approval by the BOE.

B. Significant Business Changes

This program does not relieve the taxpayer of his or her responsibility to report in accordance with changes in the California Sales and Use Tax Law and the accompanying regulations. Changes in laws may occur during the period when the approved AMRUT is in effect. During the period the approved AMRUT is in effect, the taxpayer is responsible for monitoring its purchasing practices and the California Sales and Use Tax Law to ascertain any changes that may significantly affect the taxable percentage.

The BOE must be notified within 90 days of a significant business change. If the taxpayer fails to report a significant business change within the specified period, the BOE-approved reporting method may be rescinded and the taxpayer may be liable for

any unreported use tax due from the first day of the quarterly filing period following the date of the significant business change.

Events which may result in a significant business change that are likely to affect the taxable percentage include, but are not limited to the following:

- Change in the product line
- Change in purchasing procedures (for example, implementation of cost containment programs)
- Merger or acquisition
- Discontinuation or start up of manufacturing or support facilities
- Change in application of tax due to statutory change, regulatory change or a change in the application of the law due to a court decision
- Change in the financial or accounting system (for example, utilization of a different software program to record purchases)

When the taxpayer makes a change in business practices, procedures or operations, including but not limited to those described above, the taxpayer must determine whether the event(s) results in a significant change to the agreed upon percentage. For purposes of audit, the taxpayer should retain the documentation he or she used to determine whether the event is significant.

If a change in business practices, procedures or operations occurs, the following thresholds will be used to determine whether the event is significant. A significant business change has occurred when, over a 12-month period:

1. An increase in purchases subject to use tax for the agreed-upon categories of purchases results in unreported purchases subject to use tax of \$100,000 or more in measure; or
2. For this same period, the taxable percentage calculation used to determine use tax reporting increases by 10 percent or more from the previously agreed-upon taxable percentage.

For example, if the agreed-upon taxable percentage was determined to be 10 percent, and thereafter, over a 12-month period, based upon a change in vendors from an in-state vendor to an unregistered out-of-state vendor, the actual taxable percentage increased to 12 percent, this would be regarded as a significant business change that requires the taxpayer to notify the BOE of the change. This change represents a 20 percent increase in the taxable percentage (2 percentage points difference between actual and agreed-upon taxable percentages divided by the agreed-upon taxable percentage).

If the taxpayer utilizes multiple taxable percentages for reporting, each taxable percentage should be examined individually to determine if a significant business change has occurred. Therefore, changes in business operations may result in a significant business change occurring for one or more of the taxable percentages, but not for all taxable percentages. The taxpayer may continue to utilize any approved taxable

percentages that did not incur a significant business change requiring notification of the BOE.

As provided above, the taxpayer must provide notification to the BOE of a significant business change within 90 days of the significant business change. Although the thresholds provided for determining whether a change is significant require the use of 12-months of purchases, this does not allow the taxpayer to wait 12-months after the event occurred that is deemed a significant business change before notifying the BOE. The thresholds are provided as a means of quantifying whether an event is significant. Again, the taxpayer is required to retain documentation he or she used at the time of the business change to determine whether the event is significant. This may require the taxpayer to look forward or project how the change would impact the taxable percentage over the next 12 months. If this documentation supports the fact that the change qualifies as a significant business change, the taxpayer must provide notification to the BOE within 90 days of the event. If this documentation supports the fact that the change was not expected to be significant, as defined above, and after the fact is found to be significant, the taxpayer should notify the BOE within 90 days of this discovery.

If the taxpayer anticipates that the reporting percentage is likely to fluctuate and is not likely to remain stable, the business may not be an appropriate candidate for AMRUT.

IX. POST REVIEW AND EVALUATION

The district may choose to review the records any time during the AMRUT program's term to monitor the integrity of the program or in conjunction with a sales and use tax audit.

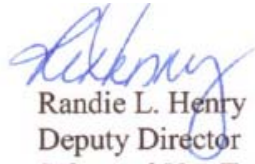
The BOE will verify the taxpayer is in compliance with the AMRUT. This includes verifying the mechanical accuracy and appropriateness of accounting procedures for all applicable accounts within the defined population.

The taxpayer's records will be reviewed to determine if there has been an unreported change in business practices and/or operations during the applicable period. The review will determine if any unreported business changes have a significant impact on the agreed-upon percentage. This may include a comparison of vendors from the original test with the list of current vendors to determine if there has been a significant change in the in-state versus out-of-state vendor distribution.

The BOE will only perform a detailed (transaction-by-transaction) test of purchases if it has previously established that one or more events have taken place that may have resulted in a significant business change. Prior to initiating a detailed test of purchases, the District Principal Auditor will review the preliminary analysis that determined a significant business change has occurred.

X. OBSOLESCENCE

This Operations Memo will become obsolete when the information contained herein is incorporated into the appropriate manuals.



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